

Tax Increment Financing and Special Taxing Districts in Maryland

A Public/Private Development Tool for the New Millennium

BY JOHN R. ORRICK, JR.

Making development pay its own way has become the mantra for local planning agencies and citizen action groups. The problem we face is that most of the existing methodologies for requiring development to pay its own way for the needed public improvements, such as proffers, impact fees, and other developer contributions, are tied incrementally to the development schedule of the project.

Two related tools, which are available in the State of Maryland to address this problem, are tax increment financing districts and special taxing districts. Both of these tools involve the issuance of tax-exempt bonds by the local jurisdiction to finance the construction of roads, sewers, and other public infrastructure, which bonds are repaid through taxes imposed on the benefited properties.

Benefits of Tax Districts

Tax increment financing and special taxing districts are a win/win/win situation for the local jurisdiction, developer, and ultimate purchaser of the benefited development. The local jurisdiction is able to ensure that the infrastructure necessary to sustain growth in the community will be built when it is needed, and not tied to the individual developer's development schedule or financial condition. Further, this financing tool is a carrot that can be used to attract development to a desired area. In the case of special taxing districts, the government is not giving up any tax revenues it would otherwise get, and in fact benefits in general real estate tax receipts through the increased valuation of the properties. In the case of tax increment financings, the local jurisdiction is still gaining improved properties and increased general property taxes on the benefited properties over the long haul, which arguably would not have been the

case absent the temporary diversion of the tax increment payments.

For the developer, a huge advantage is that the cost of constructing the public infrastructure is removed from the developer's balance sheet, which in turn reduces development costs and frees up capital resources. The developer is able to pass along the debt service obligation to the property owners as the property is improved. Further, the interest coupon on tax-exempt bonds is often much lower than the cost of capital through private banking institutions and private equity.

For the home buyer/property owner, the benefit generally includes a reduced purchase price for the real estate since the development cost is no longer incurred by the developer. The property owner will pay no additional property tax in the case of tax increment financing, or some additional tax in the case of special taxing districts, but such taxes are paid on an annual (or semi-annual) basis and are only incurred during the period of time that the property is owned by that purchaser.

Procedures to Create and Fund Tax Districts

Both tax increment financing districts and special taxing districts require actions to be taken by the county or

municipality where the proposed district is to be located to define the boundaries of the district and to authorize the issuance of municipal bonds to fund infrastructure improvements on behalf of the district. These procedures are summarized briefly below:

Tax Increment Financing Districts

Sections 14-201 through 214 of Article 41 of the *Annotated Code of Maryland* (the "Tax Increment Financing Act") authorizes all counties and municipalities in the State of Maryland, other than Baltimore City, to utilize tax increment financing for the purposes of financing the development of industrial, commercial or residential areas. The Tax Increment Financing Act authorizes the issuance of bonds to be payable from a special fund created in connection with the district which will hold the incremental tax payments. The county or municipality must designate by resolution a contiguous area within its jurisdiction as the "development district" from which the incremental tax payments are to be pledged. The portion of the annual property taxes on property located within the development district which exceeds the taxes on the "original assessable base" for such properties is thereafter to be paid into this special fund for purposes of repaying special obligation bonds issued by the county or municipality.

The Tax Increment Financing Act authorizes the proceeds from bonds issued pursuant to the Act to be applied to the following purposes:

1. The cost of purchasing, leasing, condemning, or otherwise acquiring land or other property within the designated development district

area or as necessary for a right-of-way or other easement to or from the designated development district area;

2. Site removal;
3. Surveys and studies;
4. Relocation of businesses or residences;
5. Installation of utilities, construction of parks and playgrounds, and other necessary improvements, including streets and roads to, from, or within the development district, parking, lighting and other facilities;
6. Construction or rehabilitation of buildings, provided that such buildings are to be devoted to a governmental use or purpose;
7. Reserves or capitalized interest;
8. Necessary cost of issuance of the bonds; and
9. Payment of principal and interest on loans, money advanced, or indebtedness incurred by a county or municipality for any of the purposes set out in the Tax Increment Financing Act.

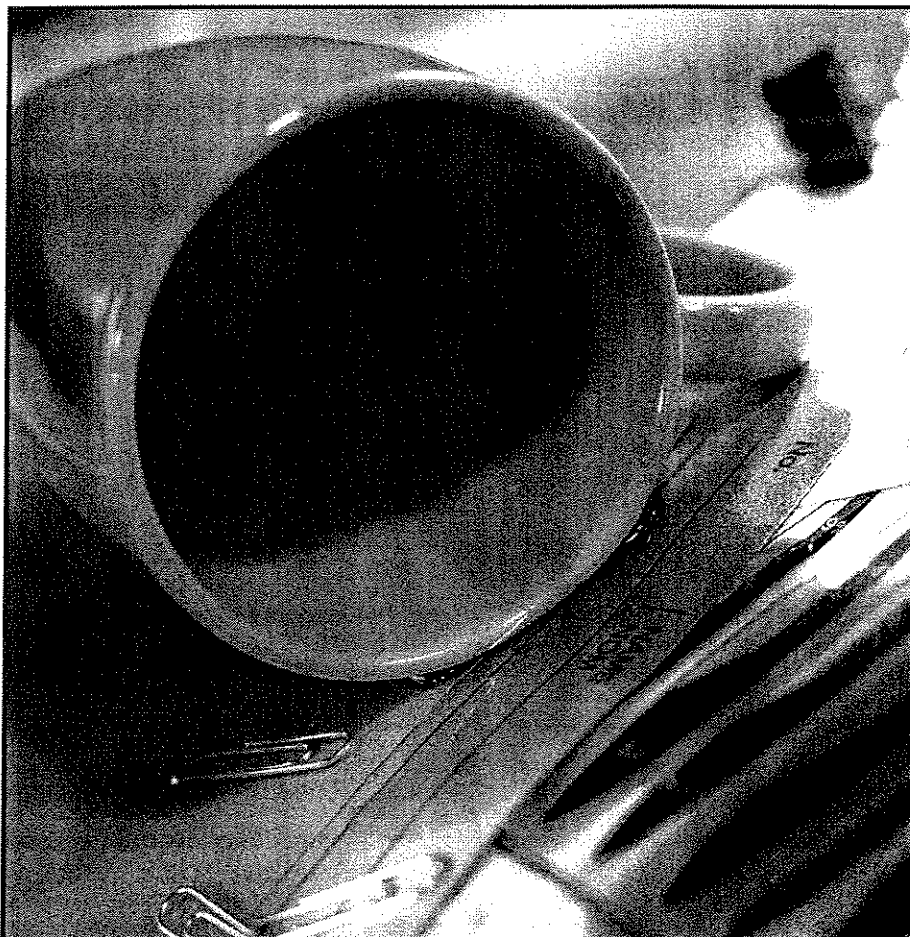
In addition to the resolution creating the special fund and designating the boundaries of the district, the county or municipality must adopt an ordinance to authorize the issuance of the bonds. The ordinance may itself specify or authorize the finance board or chief executive officer of the county or municipality to specify the terms of the bonds.

Further resolutions and ordinances may be necessary, depending upon the laws of the county or the municipality, to authorize the inclusion of the public improvements within the capital budget of the jurisdiction, and to address issues such as the applicability of local procurement regulations, the applicability of prevailing wage laws, and other requirements associated with public works agreements.

Special Taxing Districts

Special taxing districts are authorized in ten counties of the State, and all municipalities within the State. Article 44A of Article 23A of the *Annotated Code of Maryland* contains provisions for the creation of districts by municipalities and the authorization of tax-exempt bonds to finance the infrastructure improvements.

In order to institute a special taxing district, a petition must be filed with the local jurisdiction by at least two-thirds of the owners of the property to be located within the district by number and by assessed valuation. The legislative body of the local jurisdiction must then adopt by resolution: (1) the designation of an area or areas as a special



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taxing district; (2) the creation of a special fund with respect to the special district into which the special taxes are to be deposited; and (3) the authorization to provide for the levy of an ad valorem or special tax on all real and personal property within the special taxing district at a rate or amount designed to provide adequate revenues to pay the debt service on the bonds.

exempt special obligation bonds to be owned and controlled by a governmental entity.

The regulations issued under Section 141 of the Internal Revenue Code provide that the temporary use by a developer of an improvement that carries out an essential governmental function is not private business use. This test

will be satisfied if the issuer and the developer reasonably expect to proceed with all reasonable speed to develop the improvement and property benefited by the improvement, and to transfer the improvement to a governmental person, and if the improvement is, in fact, transferred to a governmental person promptly after the property benefited by the improvement is developed. Consequently, privately operated facilities, such as community association owned recreational facilities and parks,

and private streets and cul-de-sacs, are generally not eligible for tax-exempt bond financing.

The statutes provide that the special taxes are to be collected in the same manner, and are subject to the same penalties, as general ad valorem property taxes. Consequently, a failure of a property owner to pay special taxes will trigger the same provisions for notice, interest and penalties and ultimately, tax sale of the affected property, as occur in the case of a failure to pay general real estate taxes.

As is the case with tax increment financing districts, a separate municipal ordinance or resolution is necessary to issue the bonds. Additional resolutions may be necessary to include the public improvements within the capital budget and to address the jurisdiction's public procurement requirements.

Federal Income Tax Code Requirements

In addition to the state and local jurisdiction requirements, the provisions of the federal Internal Revenue Code will impact the ability to utilize tax-exempt bond financing for tax increment financing districts and special taxing districts. The main area of inquiry under the federal tax laws is whether the special obligation bonds will be deemed to be public purpose bonds as opposed to "private activity bonds" under Section 141 of the Internal Revenue Code and the regulations thereunder. The Internal Revenue Service has issued extensive regulations on this topic, and there are numerous private letter rulings and other interpretive relief which provide guidance on this question.

The basic rule under Section 141 of the Internal Revenue Code is that no more than 10 percent of the proceeds of the tax-exempt bonds may be used for any private business use. A related test is that no more than 10 percent of the proceeds of the bonds may be secured by any interest property to be used for a private business use or derived from payments in respect of property or borrowed money used or to be used for a private business use.

In order to satisfy the aforementioned tests, it is necessary for the infrastructure to be financed through tax-

Although private parties may enter into management contracts to operate public facilities, there are significant restrictions on the fees charged by private entities under such management contracts. Accordingly, developers seeking to finance through tax-exempt bonds infrastructure facilities which generate revenues, such as parking garages, will find their ability to use the revenue flow from such facilities to be severely impacted.

One solution to the federal tax limitations of private activity bonds is to authorize the issuance of a class of taxable bonds to finance the infrastructure which will not qualify under Section 141. While the benefit of the lower tax-exempt interest rate is obviously lost, the developer still enjoys the other benefits described above associated with this type of public/private financing.

Municipal Debt Underwriting Criteria

The municipal debt markets demand that certain underwriting criteria be met in connection with projects funded through tax-exempt bonds for these types of projects. Generally, these types of financings are sold without a credit rating by a nationally recognized credit rating organization, such as Standard & Poor's, since there is no credit enhancement provided to support the tax payments made by the owners of the underlying properties. Accordingly, investors will want to be sure that there is a sufficient tax base which underlies the properties included within the proposed district and that the development entity is capable of bringing the project to fruition in a timely manner.

As a rule of thumb, the value of the underlying property, as improved by the public infrastructure improvements, must generally exceed the total amount of outstanding debt supported by the tax payments by a ratio of 3:1 throughout the life of the project. If this ratio cannot be supported, which may be the case in the early years of a project, a portion of the bond proceeds may be escrowed and not made immediately available to the project.

In addition, the investors will consider the track record of the developer, the degree to which the infrastructure must be completed prior to the funding through the bond proceeds, and the financial commitments of banks and other providers of capital to the project when assessing the viability of a particular tax district. Generally, a reserve fund in an amount equal to 10% of the bond principal amount must be funded through the proceeds of the bonds to cover unexpected shortfalls in the payments, thereby increasing the cost of this type of financing.

Developer Disclosure

An important consideration with this type of financing, which is not present with conventional financing, is the requirement that the developer provide disclosure to the issuer and the bond purchasers concerning the project and the developer entity itself, both at the time of the sale of the bonds through the disclosure document provided to investors and through continuing disclosure reports which are required on a periodic basis thereafter by the bond issuer and the investing public.

Examples of Tax Increment Financing and Special Taxing Districts in Maryland

Several county created tax increment financing districts and special taxing districts have been created in the State of Maryland in recent years, and many others are under consideration at this time. Although authorized, the municipal corporations of Maryland have rarely implemented tax increment financing mechanisms. However, the City of Annapolis in conjunction with Anne Arundel County has

recently approved a tax increment financing transaction to finance the cost of construction of a public parking facility for a mixed-use project called Park Place in the City. For examples of several successful districts in Maryland, please visit the website listed at the end of this article.

Conclusion

The debate over "Smart Growth" policies has been joined in the State of Maryland and elsewhere. One of the overriding themes in this debate is the role that the public sector must play to steer development towards socially desirable areas, and away from areas that require the construction and maintenance of roads and other public infrastructure in a sprawling, haphazard manner. The tax districts described in this article are both a financing vehicle and a land planning tool which can provide incentives to the development community for projects which address these public policy concerns.

Although the creation and funding of these districts is not a simple process, and is subject to some political uncertainties, they will become increasingly important weapons in the arsenals of developers and governmental entities for directing growth in the future. ■

John R. Orrick, Jr. is a partner in the law firm of Linowes and Blocher LLP, Silver Spring, Maryland, and represents developers in tax increment financing and special taxing districts throughout the State of Maryland. For a complete, unedited copy of this article, please go to www.linowes-law.com/a-61400.htm.

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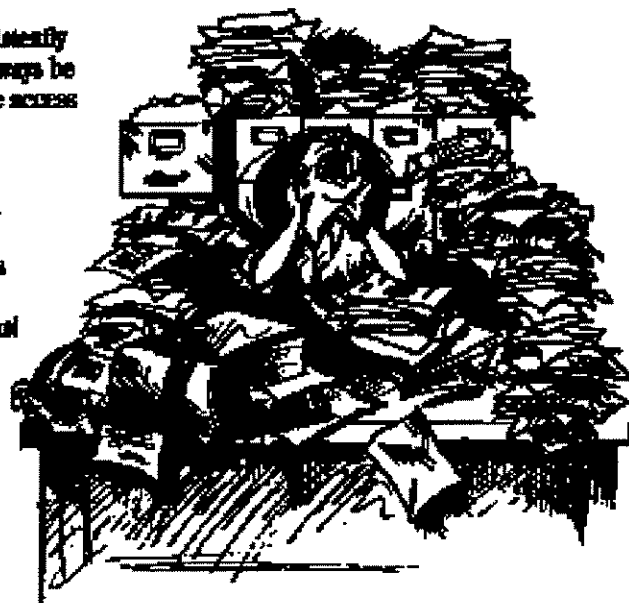
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Special Taxing Districts - A Public/Private Development Tool for the New Millennium

MONTGOMERY COUNTY FORMS SECOND TAXING DISTRICT

By Jack Orrick



In April 2002, Montgomery County will issue approximately \$16 million in special revenue bonds to fund certain road, sewer and water, and public park

improvements for the Woodcliffe Park communities being developed in West Germantown. These properties are included in a special taxing district called the West Germantown Development District, which represents the second such taxing district created by Montgomery County since the enabling legislation to authorize the creation of such districts was implemented in 1994. Other counties throughout the State of Maryland have created such districts, including a related type of district known as a tax increment financing district, and more of these districts are currently pending throughout the State.

Residents of the homes located in the West Germantown Development District will see approximately an additional \$300 to \$1,000 of special taxes added to their real property tax bills each year, which special taxes will be used by the County to pay debt service on the revenue bonds. The special taxes will continue until the bonds are repaid in full, which may not occur until 2027.

What are special taxing districts, and why are they being used in Maryland? As was the case in California in the mid-1980s when Proposition 13 was passed,

which led to the creation of special taxing districts, called "Mello-Roos" districts, to fund roads, water and sewer systems and schools, local governments in Maryland are facing increasing funding issues in providing infrastructure to support growth. These districts represent a "public-private partnership" which can prove to be quite useful in addressing the funding concerns, while providing a means for directing growth to the desired locations.

Background Of Special Taxing/Tax Increment Financing

In this era of Smart Growth, local jurisdictions are increasingly involved in directing the pattern of new real estate developments throughout our region. At the same time, pressures to reduce government spending and taxes have limited the transportation budgets of the local jurisdictions and have resulted in less new road and other public improvement construction. "Making development pay its own way" has become the mantra for local planning agencies and citizen action groups.

The problem we face is that most of the existing methodologies for requiring development to pay its own way for the needed public improvements, such as proffers, impact fees, and other developer contributions, are tied incrementally to the development schedule of the project. Furthermore, often private developers are not able to finance through banks and other conventional lending sources large

up-front payments even if the local jurisdictions require them. The result is that the construction of the needed roadways, water and sewer facilities, and other public infrastructure needed to support the new developments, are often built in a piecemeal and haphazard fashion. If the particular development does not succeed financially, or if the developer is financially burdened by other projects, the ability of the local governmental jurisdiction to realize the developer contributions can be severely impeded. Finally, even if

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the local jurisdiction actually collects developer contributions, the political nature of approving budgets for transportation and other public infrastructure spending can delay the construction of the needed infrastructure and ultimately endanger the viability of the development project.

Tax increment financing districts and special taxing districts represent two related tools which are available in the State of Maryland to address this problem. Both of these tools involve the issuance of tax-exempt bonds by the local jurisdiction to finance the construction of roads, sewers, and other public infrastructure, which bonds are repaid through taxes imposed on the benefitted properties.

In the case of tax increment financing, the differential in the local real estate *ad valorem* property tax, as measured from a baseline established prior to commencement of the development and the actual tax receipts based on the property as improved, is the source for the repayment of the bonds.

In the case of special taxing districts, an additional tax is layered above the general real estate property tax to repay the bonds. Such tax may be in the form of an additional *ad valorem* tax, a special assessment tied to the benefit created, or a combination of the two. Further, these two methods of financing infrastructure can be combined to better allocate the benefits and burdens of the public/private financing tool.

Benefits Of Tax Districts

Tax increment financing and special taxing districts are a win/win/win situation for the local jurisdiction, developer, and ultimate purchaser of the benefitted development. The local jurisdiction is able to ensure that the infrastructure necessary to sustain growth in the community will be built when it is needed, and not tied to the individual developer's development schedule or financial condition.

Further, this financing tool is a carrot that can be used to attract development to a desired area. In the case of special taxing districts, the government is not giving up any tax revenues it would otherwise get, and in fact benefits in general real estate tax receipts through the increased valuation of the properties. In the case of tax increment financings, the local

jurisdiction is still gaining improved properties and increased general property taxes on the benefitted properties over the long haul, which arguably would not have been the case absent the temporary diversion of the tax increment payments.

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For the home buyer/property owner, the benefit generally includes a reduced purchase price for the real estate since the infrastructure development cost financed through the bonds is no longer incurred by the developer. The property owner will pay no additional property tax in the case of tax increment financing, or some additional tax in the case of special taxing districts, but such taxes are paid on an annual (or semi-annual) basis and are only incurred during the period of time that the property is owned by that purchaser. The special taxes are generally structured to be fully deductible on the homeowner's federal income tax return, thus lowering the cost further.

Procedures to Create and Fund Tax Districts

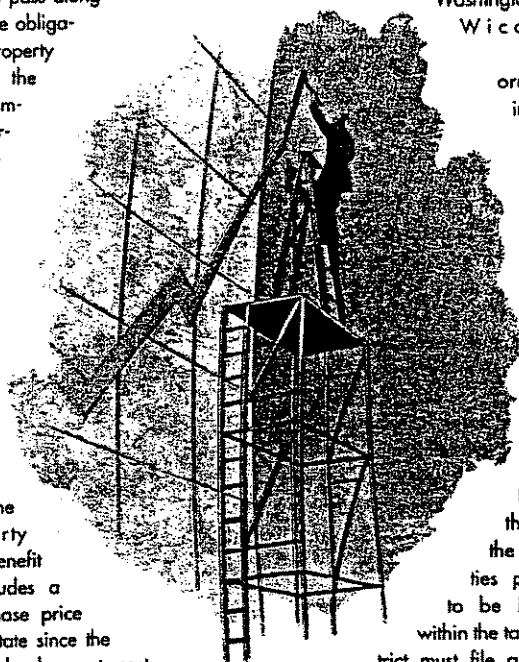
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where the proposed district is to be located to define the boundaries of the district and to authorize the issuance of municipal bonds to fund infrastructure improvements on behalf of the district.

Special taxing districts are authorized in ten counties throughout Maryland, or portions thereof: Anne Arundel, Calvert, Charles (commercial projects only), Frederick (specific election districts only), Garrett, Howard, Montgomery,

Prince Georges, Washington, and Wicomico.

In order to institute a special taxing district, the



owners of at least two-thirds of the properties proposed to be included within the taxing district must file a petition

with the legislative body of the local jurisdiction seeking the creation of such a district. A legislative body must then adopt by resolution (i) the designation of an area or areas as a special taxing district; (ii) the creation of a special fund with respect to the district into which these special taxes and assessments are to be deposited; and (iii) the authorization to provide for the levy of an *ad valorem* or special tax on all real and/or personal property within the special taxing district at a rate or amount designed to provide adequate revenues to pay the debt service on the bonds.

Tax increment financing districts are also created by the adoption of a resolution by the local legislative body of the county or municipality to create the district and to provide for the payment of a por-

tion of the general *ad valorem* taxes into a special fund to be used to pay debt service. Tax increment financing districts can be created in any county or municipality located throughout the State.

In addition to the resolutions creating the districts and authorizing the payment of special taxes or increments of general *ad valorem* taxes into special funds, the County or municipality must adopt an ordinance or a resolution to authorize the issuance of bonds. In addition, additional resolutions may be necessary to include the public improvements within the capital budget and to address the jurisdiction's public procurement requirements.

Examples Of Tax Increment Financing And Special Taxing Districts In Maryland

In addition to the West Germantown Development District, several tax increment financing districts and special taxing districts have been created in the State of Maryland in recent years, and many others are under consideration at this time. The following represents a brief summary of certain of these districts which have been successfully created.

Frederick County - Tax Increment Financing District for Toys-R-Us

A tax increment financing district was created in 1995 to allow Toys-R-Us to finance roadwork, sewers and other infrastructure for a warehouse facility located in the Dudrow Business Park. Several million dollars in special obligation bonds were issued by Frederick County for this project.

Frederick County - Special Taxing District - Urbana Community Development Authority

In 1998, Frederick County issued \$30 million in special obligation bonds to finance the construction and acquisition of road improvements to Rte. 1-270 and certain state highway intersection and collector roads and the construction, establishment and extension of a water and sewer system to properties located within a special taxing district for several developments, which included residential, retail, and office uses.

Montgomery County - Special Taxing District for Kingsview Village Center

Montgomery County issued \$2.4 million in special obligation bonds to finance the construction and acquisition of road improvements to Rte. 1-270 and certain state highway intersection and collector roads and the construction, establishment and extension of a water and sewer system to properties located within a special taxing district for several developments, which included residential, retail, and office uses.

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lion of tax-exempt bonds in 1999 to finance certain road improvements in connection with the establishment of the Kingsview Village retail shopping center and adjoining residential properties located in Germantown, Maryland.

Prince George's County - Special Taxing District for Woodview Village

Prince George's County approved the creation and funding of a special taxing district for a subdivision composed of 584 residential units in 1996 whereby \$8 million of special obligation bonds were issued to finance road and utility improvements in addition to the contribution of a recreational facility and a monetary contribution for the design, construction and extension of improvements to public schools serving the district.

Anne Arundel County - Special Taxing District - Farmington Village Project

In 1998, Anne Arundel County approved the issuance of over \$6 million of tax-exempt bonds to finance roadway, storm sewer and sanitary sewer facilities for a special taxing district formed on behalf of a residential subdivision of approximately 450 homes.

Anne Arundel County - Combined Tax Increment Financing District and Special Taxing District - Arundel Mills Project

Anne Arundel County approved in 1999 a combined special taxing district and tax increment finance district and the issuance of \$28 million of special obligation bonds to fund the cost of interchange improvements on state highways, the construction of new roadway facilities, and water, sewer, and other public utility items

for a regional mall to be built by the Mills Corporation. In this instance, the special taxes serve as a backup in the event that the revenues from the annual tax increment payments are insufficient to retire the bonds.

In addition, several special taxing/tax increment financing districts are currently pending in Montgomery, Anne Arundel and Frederick Counties, to name a few.

Conclusion

The debate over "Smart Growth" policies has been joined in the State of Maryland and elsewhere. One of the overriding themes in this debate is the role that the public sector must play to steer development towards socially desirable areas, and away from areas which require the construction and maintenance of roads and other public infrastructure in a sprawling, haphazard manner. The tax districts described in this article are both a financing vehicle and a land planning tool which can provide incentives to the development community for projects which address these public policy concerns.

Although the creation and funding of these districts can be a complex process, and is subject to some political uncertainties, they will become increasingly important weapons in the arsenals of governmental entities for directing growth in the future.

Jack Orrick is a partner in the law firm of Linowes and Blocher LLP, Silver Spring, Maryland, and is currently representing developers in several tax increment financing and special taxing districts located throughout the State of Maryland.